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C O N F I D E N T I A L SECTION 01 OF 03 AMMAN 005311

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SUBJECT: IMF ADVANCE REPORT PRESENTS STARK FISCAL PICTURE, IN LINE WITH MOF PROJECTIONS

REF: AMMAN 5228

Classified By: Charge d'Affaires David Hale for reason 1.4 (b) and (d)

¶1. (C) SUMMARY: According to advance reports, a quarterly IMF review of Jordan,s economic situation shows a dramatic deterioration in the fiscal position of the GOJ, broadly in line with figures that we have seen from the Ministry of Finance, that stems from the rise of world crude prices and the GOJ,s failure to obtain the expected level of GCC grant aid. Working with the Ministry of Finance, the IMF appears to have convinced the Cabinet of the necessity of taking drastic measures to partially rectify its fiscal position, chief among them the acceleration of the elimination of fuel subsidies from the original target date of February 2008 to January 2007. Nonetheless, the upcoming several years will see higher-than-recommended budget deficits, even if the GOJ is able to muster the political will to follow up the painful measures it is taking in 2005 with equally painful measures planned for 2006 and 2007. END SUMMARY.

¶2. (C) Emboffs have recently seen a copy of the Concluding Statement of the IMF Quarterly Post-Program Monitoring Mission (which concluded on June 15), provided to them by a GOJ official. The IMF appears from the report (and our conversation with one team member confirms this to be the case) to have been surprised by Jordan,s failure to secure its expected level of grants from the GCC states and by the continued rise in crude oil prices. The mission found the resulting budget deficit - which it estimated at 12% of GDP - to be alarming, noting in the report that without aggressive action, "the serious macroeconomic imbalances would not only reverse the progress made in the past few years in reducing the debt/GDP ratio, but could also threaten stability of the exchange rate."

ELIMINATING FUEL SUBSIDIES

¶3. (C) Given this substantial shortfall in Jordan,s budget, the IMF considers that the only option for the GOJ is to move aggressively to end fuel subsidies. The team member with whom we spoke noted that progress had already been made on this front with the GOJ. In alliance with then-Finance Minister Bassem Awadallah, the IMF had gotten an agreement from a previously reticent Cabinet to end fuel subsidies by January 2007, rather than the February 2008 date that the GOJ had previously noted as the deadline for fuel subsidy elimination.

¶4. (C) The IMF report elaborates further on this agreement: the first fuel price increases will come by early July, followed by at least two further rises by March 2006 and January 2007. (Judging from comments by PM Adnan Badran on June 28, prices will increase by approximately 30%, providing approximately $165 million in additional revenue to the GOJ during the final six months of 2005.) The accelerated schedule is intended to neutralize, at the earliest possible time, the impact of further potential world crude oil price increases. The GOJ, which already makes a surplus on every gallon of gasoline sold, would see this informal revenue source codified in the form of an excise tax on gasoline and diesel.

¶5. (C) A gap still persists, however, between the IMF recommendations on fuel subsidies and the steps that the GOJ is willing to take at this point. One sticking point has been the different estimates of the global crude oil price on which to base fuel price increases - the GOJ is still making its calculations at an estimated average price per barrel of $45, while the IMF believes $53 per barrel is more realistic given recent market pricings and projected movement of the world market. (COMMENT: Given that the break-even point for the GOJ at current Jordanian fuel prices would be at a global crude oil price of approximately $27.15 per barrel, according to MOF figures, the gap between the IMF and the GOJ on this issue is relatively small. Nonetheless, if high prices continue as the IMF projects, it may take some additional time for Jordan to eliminate all fuel subsidies - and the

difference will be apparent in the budget deficits for 2006 and 2007. END COMMENT.) Even $53 per barrel, however, may eventually prove to be too low an estimate. The IMF has therefore recommended "the adoption of quarterly automatic price adjustments in place of annual discretionary increases," but the GOJ has not indicated any intention of signing on to this idea.

FISCAL PREPARATION FOR THE END OF GCC GRANTS

¶6. (C) Of greater immediate effect to the GOJ balance sheet than the unanticipated fuel price increases has been the loss of anticipated GCC grants. The IMF currently assumes that no further grants will come from GCC states in 2005, and that even the reduced Saudi cash grant will not continue past April 2006. Given that the grants from the GCC for 2005 were expected to outweigh the fuel subsidies - even at increased prices - by at least $300 million, the budget would have needed to be cut substantially even had fuel prices remained at 2004 levels.

¶7. (C) The GOJ has begun this process by making some hard choices, though further hard choices remain to be made. A substantial cutback in capital expenditures for 2005 (by 2.4% of GDP according to the IMF report - equivalent to the $288 million in the most recent position paper that we have received from the Ministry of Finance) still represents a climbdown from former Finance Minister Abu Hammour,s repeatedly stated vow that Jordan would do no spending that was not covered by revenue or grants. (We do not have access to information on exactly what capital spending has been cut.) However, the capital spending cut being planned by the GOJ meets the recommendations of the IMF, who have proposed substantially smaller capital spending reductions for the projected 2006 and 2007 budgets. In any case, the reduction in capital spending will contribute more heavily to the stabilization of Jordan,s fiscal position in 2005 than the projected additional revenue from the increased fuel prices.

¶8. (C) The IMF language on the medium-term steps that the GOJ has agreed to take to raise revenues and cut expenses is also generally positive. The IMF has received a verbal agreement from the GOJ to remove all food subsidies in 2006, though the increased expenditure on a social safety net (providing the neediest 20% of Jordanians with assistance in procuring food and fuel) will counterbalance most of the savings from this measure; they have also recommended that the GOJ freeze all current expenditures except for pensions at 2005 levels - a step that would cut GOJ projected expenditures by an average of slightly less than $130 million per year during the projected period. The IMF staff member with whom we met viewed the King,s regional decentralization proposal as a key threat to the freeze in current expenditures, as the potential addition of elected officials and staff for this purpose would not only add additional current expenditures itself, but also make it harder for the GOJ to hold the line against other requests. (NOTE: He also repeated the often-heard rumor that the USG was behind this initiative.)

¶9. (C) The IMF has had less success in receiving GOJ concurrence in the partial and total elimination of exceptions to the GST for certain products taxed at a lower rate than the 16% standard rate, only securing agreement from the government for elimination of partial exemptions on hotel rooms, alcohol, and cigarettes and a vague statement of intent to double GST rates levied on some exempted goods and services currently taxed at the lowest rate (from 4% to 8%) in 2006. The potential revenue gain foregone by the GOJ by its more selective (and delayed) policy on increases, however, only totals around $85 million over the two-year period of 2005-6.

¶10. (C) The IMF report also endorses GOJ,s restructuring of Jordan,s income tax code to flatten the tax rate and improve collection. It notes, however, that positive effects on revenue are unlikely to appear before 2007, and the IMF makes no attempt to quantify the potential returns of such a tax.

¶11. (C) Finally, the IMF report appears to regretfully accept that rather than reducing the GOJ,s stock of debt, the proceeds coming in from the GOJ,s accelerated privatization program over the next three years will likely be used to finance part of the GOJ deficit. These anticipated revenues, though they are not cited in the IMF report, probably underlie the GOJ,s optimistic prediction of a budget deficit amounting to 5.1% of GDP (rather than the 12% deficit projected based on commitments in the original GOJ budget) in
¶2005.

OTHER ECONOMIC CHALLENGES

¶12. (C) In addition to their effects on the fiscal deficit, the IMF report notes that the loss of GCC grants and the rise

in oil prices would further widen Jordan,s current account deficit. The IMF team views the recent large portfolio capital inflows to Jordan as a potential additional element of risk to currency stability and advocates a tighter monetary policy on the part of the Central Bank of Jordan (CBJ). Ultimately, the IMF does not foresee a serious near-term risk to the exchange rate, though it noted that the CBJ would likely have to draw down its reserves to some degree over the upcoming year.

¶13. (C) The IMF notes a final risk to Jordan,s economy stemming from the possibility of a dramatic reduction in the value of the currently inflated Amman Stock Exchange, draws attention to the exposure of Jordanian banks to the stock market, and calls on the relevant authorities to be vigilant. It also notes the necessity of swift passage of an anti-money laundering law.

COMMENT

¶14. (C) That the IMF now considers the attainment of a 5.1% (of GDP) deficit in the GOJ budget in 2005 and a 6.5% deficit in 2006 to be best case scenarios in the absence of further, unanticipated grant aid is a testimony to how drastically the fiscal position of the GOJ has been transformed by the continued rise in crude oil prices and the government,s failure to obtain 2004 levels of grant aid from the GCC states. The IMF, in its summary, notes that if all of their recommendations are followed to the letter, Jordan might barely meet the requirement specified in its Public Debt Law that sovereign debt be reduced to 80% of GDP by the end of ¶2006. However, an economic downturn - or even a slowed rate of growth - driven by the effect of the substantial fuel price increases to the competitiveness of Jordanian industries and to Jordanian consumer spending may mean that the GOJ will be unable to meet this target. This likely will mean an undiminished drive by the GOJ for further debt swaps and debt forgiveness. If the latter is unsuccessful, there will likely be increasing pressure for an amendment to the Public Debt Law extending the deadline for achievement of the target.

¶15. (C) The good news of this story, for the IMF, is the way in which the GOJ has reacted to its sudden reversal of fortune. By force of necessity - and, it appears, aided by straight talk from the IMF on the severity of Jordan,s fiscal position - the GOJ is now making concerted steps to end its dependence on grants from its Arab neighbors that have always been uncertain. Nonetheless, the painful budgetary adjustments that now appear to be a fait accompli for 2005 will have to be followed by equally painful adjustments in 2006 and 2007 in order for the GOJ to safely maneuver into its new budgetary equilibrium. To maintain the requisite political will to endure this pain over an extended period, the GOJ will require the strong support of its friends and their constant reinforcement of the message that the IMF has delivered.
HALE